In the Supreme Court
of the
United States

October Term, 1954

No. [redacted]

[redacted]

Petitioner,

vs.

[redacted]

Respondent.

Subject Index

Table of Authorities Cited

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1954

No. 793

UNITED STATES OF AMERICA,
Petitioner,

vs.

LESLIE SALT CO.
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF FOR RESPONDENT IN OPPOSITION.

OPINIONS BELOW.

The District Court's opinion is reported at 110 F. Supp. 680. The opinion of the Court of Appeals is reported at 218 F.2d 91.

JURISDICTION.

Jurisdiction is as set forth in the Petition.

QUESTION PRESENTED.

Whether two instruments issued by a borrower to two insurance companies are what they purport to be and as the District Court and Court of Appeals found —promissory notes and not subject to tax—or are said instruments "debentures" and thus subject to tax within the meaning of Section 1801 of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED.

The statute and regulations involved are set forth in the Petition at pp. 2-4.

STATEMENT.

In substance, the statement made by petitioner amounts merely to a purported summary of the documents involved (R. 87-133) and said documents can and do speak for themselves. Entirely omitted from petitioner's statement is any discussion of the testimony of the witnesses called, this testimony describing in detail the differences between "debentures" and "promissory notes" of the type here involved as those terms are used and understood in the business and financial community. Our statement will attempt to cure this omission.

On examination of the whole record, it is apparent that promissory notes on the one hand and debentures on the other have some similarities but that they also have significant differences. The key to the differences lies in the conflicting purpose each instrument is de-

signed to serve. A debenture is designed for public offering and for easy resale if the purchaser so desires. Its terms, appearance and methods of sale are designed to accomplish this result. A non-negotiable promissory note (such as the two involved in the instant case) by its very nature cannot be offered for sale to the general public, nor can such a note be readily resold. Of course it is conceivable that instruments entitled "debentures" could be offered to only one lender and that said instruments could contain all terms customarily appearing in debentures. However, this procedure would be pointless unless the buyer, in turn, contemplated resale to the investing public and wanted to avoid the necessity of retiring an old instrument and the substitution of debentures before making a public offering (R. 72).

The difference in *purpose* between a debenture and promissory note should be kept in mind in evaluating the evidence we now discuss.

First, the method of sale. Leslie Salt Co. needed more money and had one of its directors approach the two insurance companies which made the loan (R. 49). No other prospective lenders were approached, and all negotiations were carried on directly between the two insurance companies and the borrower without the services of an investment banker or other intermediary (R. 49). The two lenders took the initiative in drafting the terms of the loans, the terms were discussed, and the loans were closed in San Francisco (R. 50). By contrast, debentures are sold as other corporate securities are sold in that they are offered to the ultimate buyers through the chan-

nels of investment bankers who employ their own distribution facilities (R. 62). The investment bankers act as middlemen in that they use their capital to purchase the issue and then resell to the public (R. 62, 63). The terms involved with respect to debentures are negotiated between the borrower and buying investment banker, or, in the case of competitive bidding, they are fixed solely by the borrower. But so far as the *ultimate* lender is concerned, terms are already fixed and his sole choice is limited to buy or not to buy. The two insurance companies making the Leslie loans were not presented with such a take-it-or-leave-it proposition; here the *lenders* took the initiative in presenting terms—the exact converse to the situation present when buying a debenture.

Although the services of an investment banker may be employed in the private placement of a promissory note, its role is that of a negotiating agent and neither its capital nor its distribution facilities are employed (R. 63). The notes may be placed without the aid of an investment banker at all, which was the case with Leslie (R. 63).

Other characteristics of a debenture sale as contrasted to the sale of a promissory note are (a) a sale of debentures is customarily advertised by an accompanying circular or prospectus, (b) a prospectus is filed with the Securities and Exchange Commission if the sale is of any size, (c) it is customary to attempt to obtain clearance with various state blue sky law commissions, (d) the underwriters request an opinion of counsel as to the legality of investment by various financial institutions (R. 70-71).

After original sale, debentures are constantly bought and sold and otherwise traded in after original issuance, and public quotations are made as to the going price (R. 69-70). There is no such after-market for notes such as the present ones (R. 70), and the court will see that the lenders are acquiring the present notes for their own account and not for resale (Pl. Ex. 3, R. 45, 100).

With respect to terms and appearance, a debenture is accompanied by an indenture containing various protective provisions to protect the purchaser, and provision is made for an independent trustee to enforce the rights of the buyers as contained in the indenture (R. 61). The Leslie Salt Co. notes are accompanied by loan agreements which on their face are likewise designed to protect the lenders (R. 93). However, no trustee is created. The purpose of a trustee in connection with a debenture issue is that debenture issues are widely held and traded in, and individual debenture holders are in no position to effectively protect their rights (R. 62). When two informed lenders alone are involved, as is true with the Leslie Salt Co. loans, no trustee is needed. Protective features are usually more severe with respect to notes than for debentures (R. 61). Debenture certificates are prepared in a form to be negotiable and have the word "debenture" printed on them, or engraved, together with destrictive covenants (R. 72). None of these features appear on the Leslie Salt Co. notes.

As to amount, debentures are usually offered in units of $1,000, or multiples thereof (R. 62). It is self-evident that the relatively small denomination of debentures is again designed to facilitate a wide distribution and easy

resale, whereas notes such as the Leslie Salt Co. notes, in the amount of $1,000,000 and $3,000,000, respectively, are too high in price for such purpose.

The District Court made a finding of fact that the two promissory notes were what they purported to be and did not have the characteristics that would make them "debentures" *as said term is commonly defined* (R. 31). Accordingly, it entered judgment for respondent (R. 34-35). The judgment was affirmed by the United States Court of Appeals for the Ninth Circuit on December 16, 1954 (R. 142).

ARGUMENT.

Respondent concedes that the decision below is in conflict with the earlier result reached by the United States Court of Appeals for the Fourth Circuit in *Commercial Credit Co. v. Hofferbert*, 188 F.2d 574 (4th Cir. 1951). However, that case stands alone, has not been followed by any of the five Courts of Appeals which have subsequently considered the present problem, and appears to have lost all vitality. It is submitted that the Fourth Circuit can be relied upon to correct its earlier erroneous position when presented with a subsequent case, just as the Second Circuit has since repudiated the erroneous reasoning of its earlier opinion in *General Motors Acceptance Corp. v. Higgins*, 161 F.2d 593 (2d Cir. 1947), cert. denied, 332 U. S. 810, 92 L. Ed. 387, 68 S. Ct. 111 (1947), which case was followed by the Fourth Circuit in reaching its incorrect result. The present problem of the Internal Revenue Service referred to at page 18 of

the Petition is entirely of that body's own making. It need only follow its earlier and correct administrative interpretation of the statute, which interpretation existed from 1924 until 1947, and the weight of judicial opinion, and the problem will disappear. It is submitted that there is no need for this Court to write a regulation for the Internal Revenue Service, as Petitioner in substance urges, and that certiorari should be denied.

I. THE TREND OF JUDICIAL OPINION IS SUCH THAT THE PRESENT CONFLICT SHOULD BE RESOLVED WITHOUT NECESSITY FOR GRANTING CERTIORARI.

The effort of the Internal Revenue Service to tax promissory notes as "debentures" within the meaning of §1801 of the Internal Revenue Code of 1939 had its first origin with the unexpected success of the Government in *General Motors Acceptance Corp. v. Higgins*, 161 F.2d 593 (2d Cir. 1947), cert. denied, 332 U. S. 810, 92 L. Ed. 387, 68 S. Ct. 411 (1947). From the contents of the opinions, it would appear that the first serious contention that the notes involved in the *General Motors* case were taxable as "debentures" was made before the appellate court, since the Treasury had apparently earlier contended only that the instruments were taxable as "corporate securities" because of their appearance and the fact that they were allegedly in registered form. *General Motors Acceptance Corporation v. Higgins*, 60 F. Supp. 979, 981 (S. D. N. Y. 1945). Following its success in the *General Motors* case in somehow converting tax-free notes into taxable debentures, an effort which the Dis-

trict Court below aptly described as an attempted "feat of catalytic baptism", 110 F. Supp. at 681, the Bureau of Internal Revenue reversed its time-honored practice of regarding notes such as those involved in the instant case as non-taxable and attempted to impose a tax. It did, however, have the grace not to apply its new ruling retroactively. This change of position is reported in M. T. 32, Cum. Bull. 1948-2, page 160. We quote from a portion of said ruling as follows:

> "*The Bureau has for a considerable period of time held that an instrument termed 'note,' not in registered form and issued without interest coupons, is not subject to the stamp tax upon issuance or transfer.* Because of this long and uniform holding of the Bureau and the consequent reliance of corporations on these rulings, it has been concluded that, under the authority contained in section 3791 (b) of the Internal Revenue Code, the decision in *General Motors Acceptance Corporation v. Higgins, supra*, will not be applied retroactively, except that any tax which has been paid on the issuance or transfer of instruments falling within the scope of the decision will not be refunded." (Italics added.)

The attempted re-writing of the statute by the Bureau failed, however, to receive sustained judicial approval. It was successful in persuading a District Court in Maryland to follow its views. *Commercial Credit Co. v. Hofferbert*, 93 F. Supp. 562 (D. Md. 1950). In so doing, however, the District Court followed the erroneous reasoning of the *General Motors* case, apparently without independent analysis. This decision was affirmed by the Fourth Circuit in a per curiam opinion, 188 F.2d 574,

again without independent analysis. Since this decision was reached, however, and on more mature consideration, the Courts of Appeal for five circuits, counting the decision below, have passed on the question of whether notes similar to those in the instant case should be taxed. The result of each of said cases has been opposed to the views of petitioner. These cases, other than the one below, are as follows: *Belden Mfg. Co. v. Jarecki*, 192 F.2d 211 (7th Cir. 4951); *Allen v. Atlanta Metallic Casket Co.*, 197 F.2d 460 (5th Cir. 1952); *United States v. Ely & Walker Dry Goods Co.*, 201 F.2d 584 (8th Cir. 1953); *Niles-Bement-Pond Co. v. Fitzpatrick*, 213 F.2d 305 (2d Cir. 1954); *Curtis Publishing Company v. Smith*, Supp. Vol. CCH Fed. Tax Serv. Par. 49, 114, 4 P-H 1955 Fed. Tax Serv. Par. 72, 636 (3d Cir. 1955). There have been no decisions by a United States Court of Appeals subsequent to the *Commercial Credit* case in favor of Petitioner, though on what must be regarded as a peculiar set of facts the Court of Claims has handed down a decision opposed to the taxpayer there involved. *Stuyvesant Town Corp v. United States*, 124 Ct. Cl. 686, 111 F. Supp. 243 (Ct. Cl. 1953), cert. denied, 346 U. S. 864, 98 L. Ed. 375, 74 S. Ct. 102 (1953).

It will be noted that one of the cases favorable to the taxpayer listed above, *Niles-Bement-Pond*, was decided by the same court which decided the *General Motors* case. In so doing, the Second Circuit distinguished its earlier opinion. As we will later demonstrate, the *result* of *General Motors* is not wholly in error; our objection lies solely with respect to certain unfortunate language contained in the opinion. This language was in substance

repudiated in the *Niles-Bement-Pond* case, and, it is submitted, the Fourth Circuit can also be relied on to correct its views when presented with a second case without necessity for granting certiorari in the instant case.

We should add that two cases on facts similar to those at bar, and which are adverse to the taxpayer, are now on appeal before the United States Court of Appeals for the Sixth and First Circuits, respectively, which have not previously passed on this question. These cases are *United States v. General Shoe Corp.*, 117 F. Supp. 668 (M. D. Tenn. 1953); and *S. S. Pierce Company v. United States*, 127 F. Supp. 396 (D. Mass. 1954).[1] In the event that the appellate courts fail to correct the erroneous results below in these two instances, we anticipate a greater need for certiorari, but the obvious remedy of petitioner is to seek amendment of the statute, as it has had abundant opportunities to do, if dissatisfied with the weight of judicial opinion on the subject. We urge that a grant of certiorari in the present case would be premature.

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[1] There have been three other recent decisions concerning the present issue before the district courts. These cases are *Sharon Steel Corp. v. United States*, Supp. Vol. CCH Fed. Tax Serv. Par. 49,107 (W. D. Penn. 1955); *Follansbee Steel Corp. v. United States*, Supp. Vol. CCH Fed. Tax Serv. Par. 48,108 (W. D. Penn. 1955); and *United Air Lines, Inc. v. United States*, Supp. Vol. CCH Fed. Tax Serv. Par. 49,088, 4 P-H 1955 Fed. Tax Serv. Par. 72,567 (N. D. Ill. 1955). Only the *United Air Lines* case has as yet been appealed, according to the tax services. That case was favorable to the taxpayer and will no doubt be affirmed in view of the appellate court's earlier decision in *Belden Mfg. Co. v. Jarecki*, *supra*. Of the other two cases, the *Follansbee* decision was for the taxpayer, the *Sharon* decision opposed.

II. THE DECISION BELOW IS CLEARLY CORRECT.

In *United States v. Isham*, 17 Wall. 496, 504, 21 L. Ed. 728 (1873), this Court held, in referring to the stamp tax statute:

> "The words of the statute are to be taken in the sense in which they will be understood by that public in which they are to take effect."

The sense of the words used in the statute according to the understanding of that public in which they are to take effect has been conclusively established by the evidence received in this case and previously discussed. That evidence disclosed that the significant feature of a debenture is ready marketability as contrasted to the promissory notes here sought to be taxed. The terms, appearance and method of sale of debentures are all designed to achieve this result, and even the Internal Revenue Service would not have contended that the present notes were taxable debentures prior to the decision in *General Motors Acceptance Corp. v. Higgins*, 161 F.2d 593 (2d Cir. 1947), cert. denied, 332 U. S. 810, 92 L. Ed. 387, 68 S. Ct. 111 (1947).

In the *General Motors* case, relied on by Petitioner and the case which persuaded the Bureau of Internal Revenue to reverse its prior administration construction of the statute, it appears from the opinion of the lower court, 69 F. Supp. 979, that the taxpayer sold 84 notes, varying in denomination from $100,000 to $1,000,000, 13 of said notes payable to the order of designated persons, 71 payable to bearer. All were negotiable. In assessing a stamp tax, the Commissioner relied primarily on the

appearance of the notes and regarded them as being issued in *registered form*. The case was tried on stipulated facts, and no testimony was offered or received as to the proper classification of the notes, 60 F Supp. at 981. The appellate court held that the instruments in question were debentures, reversing the trial court's judgment in favor of the taxpayer.

The instruments in the *General Motors* case are distinguishable on the facts for the following reasons: (1) *Appearance*. The *General Motors* notes were tinted, engraved, bore serial numbers and the corporate seal, and otherwise, so far as appearance was concerned, bore every evidence of the ordinary corporate bond, debenture or other corporate security. These factors do not exist with respect to the Leslie Salt Co. notes. (2) *Terms*. The notes were negotiable as is customary with bonds or debentures, and were not in the nature of a simple contract to borrow and lend money as is true in the instant case. (3) *Mode of Sale*. Unfortunately, the facts are incomplete in this respect as reported in the two opinions. These omissions, however, are cured by reference to the case of *Belden Mfg. Co. v. Jarecki*, 192 F. 2d 214 (7th Cir. 1951), which discusses the record in *General Motors* which had been received in evidence. It appears that the sequence of events was first to print and engrave the notes, and second to offer the same for sale to the highest bidder in the investment public. The above sequence is that typically employed in the marketing of bonds, debentures or other corporate securities.

By contrast, the loans in the instant case were negotiated from beginning to end with only the two lending institutions which ultimately made the loans; terms were discussed before being reduced to writing, and the loan contracts, as ultimately executed, were the result of *prior* negotiations, not instruments which the borrower first executed, then sold to the highest bidder from the investing public.

In assessing the correctness of the *General Motors* case, it appears to the undersigned that the result is not wholly in error, since many features of the transaction were similar to debenture financing. Our objection goes to certain unfortunate statements contained in the opinion, which statements have since been repudiated by the same court in *Niles-Bement-Pond Co. v. Fitzpatrick*, supra. Our first objection to the language of the *General Motors* case goes to the attempt by the court (161 F. 2d at 596) to draw a distinction between what it calls "ordinary promissory notes" and notes which fall "into the category of debentures as that term is used in the statute in its setting with bonds, and certificates of indebtedness, to designate a type of corporate securities which does not include ordinary promissory notes." There is, of course, no statutory justification for drawing such a distinction, and the court was consequently unable to point to any language of the present or prior statutes to support its conclusion. The court also stated that the method of sale to a few investors who indicated their then intention not to resell was a key factor in throwing

the notes in question into the same general category as debentures and other corporate securities rather than in the category of ordinary promissory notes.

It is probable that the court fell into this latter error due to the fact that the taxpayer failed to offer any testimony as to how the instruments in question should be classified. With only the instruments before it the appellate court failed to realize that bonds, for example, are commonly widely sold, are constantly resold, and that it is unheard of in business and financial circles for a corporation to issue bonds or other corporate securities which it proposes to sell to one or two investors conditioned on the assurance by said investors that they do not plan to resell. As brought out by the record in the instant case, debentures are the same as bonds in this respect.[2] The very point which distinguishes a debenture bond or other corporate security from a promissory note is that they are continuously traded in after issuance and sold to a wider public; the facts the court relied on in stating that the notes were debentures are the precise facts which weakened such a holding.

In *Niles-Bement-Pond Co. v. Fitzpatrick*, 213 F. 2d 305 (2d Cir. 1954), the Court of Appeals distinguished its earlier opinion in the *General Motors* case, repudiated its earlier view that the only promissory notes exempt from tax were those "used customarily in day to day com-

[2]Though an issue of bonds or debentures might be sold to a single buyer if that buyer in turn planned to resell (R. 72).

mercial transactions of a short time credit character" and, by placing the emphasis on marketability as the typical characteristic of a debenture, also repudiated the earlier view that restrictions on transfer pushed an instrument into the classification of debentures rather than the converse.

It is submitted that in the instances where a court has ruled adversely to a taxpayer on facts similar to those at bar, the courts concerned have done so only by ignoring the language of the statute and speculating about the motive or state of mind of the borrower or lender or otherwise adding tests which do not appear in the plain language of the act which must control the result here. If Congress had wished to single out insurance company loans for taxation, nothing could have been easier than to say so. If loans of substantial amount and duration should be taxed and the small loan left free of tax, certainly Congress would have had no difficulty in saying as much. It is urged that the court below was clearly correct in commenting (R. 141):

> "We cannot but feel that in the considerable number of instances where courts have upheld exactions of the tax in situations analogous to the present they have invaded a field belonging exclusively to Congress."

CONCLUSION.

For the foregoing reasons it is respectfully submitted that this petition for a writ of certiorari should be denied.

DATED, San Francisco, California,
May 25, 1955.

Respectfully submitted,

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